

Supporting funding and financing efficiency on an international basis

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The need for firms to maintain exemplary standards of collateral and liquidity management has assumed unprecedented importance. In many cases, the changes required to meet these standards do not mark a revolutionary departure from the past. For more than a decade, banks have been moving away from borrowing through unsecured channels towards collateralised lending mechanisms. Throughout this period, firms have been focused on how they can mobilise and allocate collateral efficiently and minimise fragmentation of collateral across geographical locations and product silos. In 2017, these remain priority areas for many financial services companies. However, the cost of failing to do these tasks well is perhaps higher than ever before and may result in severe damage to a firm's profitability or reputation.

As so often the case in financial services, regulation has been a primary driver for reform in this area. The move towards secured funding and financing mechanisms requires that firms can access eligible collateral quickly and at affordable cost. The overarching message is that good quality collateral is a precious resource that needs to be managed carefully.

Opportunities and obligations

With these developments comes a wave of new opportunities for firms that are forward-looking and agile enough to respond effectively. However, it also brings with it a host of new obligations, requiring a constant eye on regulatory and legal compliance and constant vigilance that fiduciary obligations are being met to investors and customers.

These pressures to adapt have been complicated by a challenging macro-economic climate which, for much of the period since the 2008 global financial crisis, has combined weak growth in many mature global economies with near-zero interest rates. Faced with these conditions, central banks have adopted unconventional measures in order to protect price stability and to guard against further economic contraction in the face of fragile business confidence.

With limited room for manoeuvre in terms of adjustment of their policy rates, central banks have provided liquidity injections through long-term refinancing operations and through massive asset purchasing programmes, in addition to providing forward guidance to the market about future policy action designed to keep the economy in track with specified inflation targets.

In confronting these uncertainties, a major question for financial services companies and other corporates is how the end of quantitative easing and the unwinding of central bank asset purchasing programmes will affect their strategy options and impact their business performance. For some time, economic forecasters have been anticipating that leading central banks will raise interest rates and will call an end to their asset purchase programmes – but unfavourable economic data has prompted monetary policy committees to delay these actions.

We believe it unlikely that the ECB will terminate its asset purchasing programme before the end of 2017. However, from 2018 we anticipate a gradual and cautious wind down. There is little doubt that this tapering process will be tightly controlled, with minimal danger the ECB will risk a drain on liquidity by flooding large quantities of high-grade assets back into the market. Policy makers are emphatic that the termination of quantitative easing must not impair business recovery or push the economy back towards a low growth cycle. Thus, any sale of assets will be carefully managed and it is likely that the ECB will hold a sizeable component of this Public Sector Purchase Programme (PSPP) asset pool through to maturity. Given that some of these assets are government bonds with 10-30 year terms, this will ensure the PSPP has an impact on liquidity conditions and bond yields well after the asset purchase programme has been brought to a close.

One implication of this development is that there will be significant demand for, and restricted supply of, high-grade assets held in quantity in this PSPP pool. Consequently, it is important that central banks support controlled lending of these assets back into the



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market to meet this demand. For example, assets purchased under the PSPP have been available for lending on a decentralised basis by the Eurosystem's national central banks through a service provided through the Bank of Italy and Deutsche Bundesbank via the Clearstream ICSD. Lending of PSPP securities holdings takes place on a cash neutral basis, whereby repo transactions against cash collateral are accompanied by a fully offsetting reverse repo transaction for the same value date and, in principle, with the same counterparty.

Managing collateral pressures

Faced with these challenges, the efficiency of collateral movement and settlement in Europe is likely to benefit substantially from the launch of the Eurosystem's TARGET2-Securities platform for the settlement of euro-denominated, and some non-euro, securities. We are confident that the release

of 1 capital savings for all euro-area banks (Clearstream and PricewaterhouseCoopers, *The 300-billion-euro question: Survey on the Benefits of TARGET2-Securities*, August 2013).

Although implementation of T2S Wave 4 was only completed in early February, there are already signs that release of this platform is delivering settlement efficiency benefits to customers. With this facility in place, just one internal booking on T2S is necessary to facilitate movement of collateral to where it needs to be in the T2S zone. Within this framework, there are very real benefits that can be delivered to clients through provision of an efficient and cost-effective investor CSD facility to support cross-border collateral settlement throughout the T2S system. At Clearstream, we have been supporting securities settlement in central bank money on a domestic basis since our formation. With the launch

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of T2S offers opportunities for sizeable capital savings under Basel III rules. In previous research, we have noted that (drawing on cross-border settlement data for Clearstream's ICSD and Clearstream's CSD in Germany) through utilising a single central bank money cash account in T2S – rather than managing central bank money settlement liquidity in separate accounts on a market-by-market basis as was the case prior to the release of T2S – customers may be able to reduce their average daily cash or credit requirements during peak settlement periods by approximately 15 per cent. Projecting this figure across the eurozone, we predicted that this will translate under Basel III requirements to €33 billion in Tier

of T2S, we now have the opportunity to deliver an investor CSD facility that enables cross-border securities settlement to take place as efficiently as it happens in the domestic market. With 24 participating CSDs linking to the T2S system, this offers enormous potential for facilitating the fluid movement of collateral and for bringing additional efficiency to the market.

With this development comes an important step forward in addressing concerns over the rising cost and risk that collateral settlement failures will present to the market in coming years. Some commentators have predicted that if industry participants continue with their current levels of STP



and process automation, and collateral settlement fail rates persist at their current levels, this will represent an unmanageable overhead to the industry in years to come.

However, the range of solutions that we have discussed in this article provides a strong foundation for addressing these concerns. T2S will simplify the challenge of mobilising and allocating collateral – and it may permit users to deploy collateral cross-border without relocating it from its domestic market. If a customer is holding assets in Clearstream’s German CSD, for example, and it wishes to allocate these as collateral to access central bank liquidity in another market, it is no longer necessary to move the collateral in order to complete these monetary policy operations. The client

in order to hedge input prices or foreign exchange exposures, to manage interest rate risk and so on. For these customers, efficient collateral and liquidity management is a daily priority and a crucial determinant of their business performance.

With this in mind, it is important that firms take necessary steps to reduce collateral fragmentation not just across geographical locations but also across product lines within the organisation. Although this collateral fragmentation has long been recognised as a key point of inefficiency, the desire of individual trading desks and product areas to maintain autonomy over their collateral and liquidity management strategies has sometimes impaired efforts to move to a more integrated “enterprise-

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will be able to access central bank liquidity in a range of locations while the collateral remains in custody in the local market.

In maximising the impact of this innovation, a primary consideration is to ensure that these potential benefits are available to as wide a section of the financial services community as possible. It remains important to extend buy-side access to a broad range of products that will deliver maximum efficiency in their use of collateral and liquidity. A growing number of buy-side firms wish to develop a more detailed understanding of how they can improve their efficiencies in these areas – and some firms are looking to take direct ownership of these activities through reinforcing their in-house expertise and working with the right service partners. So too, this is true of the corporate sector, which in some cases may move huge volumes of cash through their treasury divisions and may be major users of derivatives

wide” approach. This has resulted in each product silo managing its own independent pool of collateral, each concentrating primarily on its own P&L rather than focusing first and foremost on optimising efficiency across the organisation.

Over time, more and more firms will be unwilling to carry these inefficiencies. The key as a collateral management specialist is to facilitate efforts of these firms to move towards more efficient operational practices, facilitating mobilisation and allocation of collateral across locations and product areas. Already we have the potential to deliver greater efficiency by offering re-use of collateral and by enabling firms to cross-net exposures across products. As financial regulators become comfortable with these options and users become confident in their use, this promises major efficiency gains that we can offer to the collateral management segment. ■